No. 97-1418

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION,
Petitioner,
v.
203 NORTH LASALLE STREET PARTNERSHIP,
Respondent.

**On Writ of Certiorari to the
United States Court of Appeals
for the Seventh Circuit**

BRIEF OF RONALD MANN, ROBERT K. RASMUSSEN, BARRY ADLER, JAMES BOWERS, DANIEL L. KEATING, ERIC A. POSNER, ALAN SCHWARTZ, DAVID A. SKEEL, JR., AND JAMES J. WHITE, AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF *AMICUS CURIAE* [1]

With the written consent of the parties, reflected in letters on file with the Clerk, the undersigned bankruptcy law scholars submit this brief as *amicus curiae*, pursuant to Rule 37 of the Rules of this Court.

[1] In accordance with Supreme Court Rule 37.6, the law professors appearing as *amicus curiae* represent that no party other than themselves authored this brief in whole or in part, and no person or entity, other than Vanderbilt Law School, which paid for the printing of this brief through Professor Rasmussen's research acount, has made a monetary contribution to the preparation or submission of this brief.

Amici are teachers and students of bankruptcy law. They are Ronald Mann, Assistant Professor of Law, University of Michigan Law School (counsel of record), Robert K. Rasmussen, Professor of Law, Vanderbilt University Law School, Barry Adler, Professor of Law, New York University School of Law, James Bowers, Professor of Law, Louisiana State University Law Center, Daniel L. Keating, Dean and Professor of Law, Washington University School of Law, Eric A. Posner, Professor of Law, University of Chicago Law School, Alan Schwartz, Professor of Law, Yale Law School, David A. Skeel, Associate Professor of Law, Temple University School of Law, and James J. White, Professor of Law, University of Michigan Law School. They submit this brief *pro se*, representing no institution, group, or association. Their sole purpose is to offer what assistance they can to this Court as it considers and decides this important case about the interpretation of the Bankruptcy Code.

SUMMARY OF ARGUMENT

1. This Court need not venture beyond the language of the Bankruptcy Code to resolve the issue before it. When, as in this case, a class of unsecured creditors both is not paid in full and dissents from a proposed plan of reorganization, no prepetition equity holder may "receive or retain under the plan on account of [its] interest any property." 11 U.S.C. § 1129(b)(2)(B). All agree that the plan at issue in this litigation gives "property" to the prepetition equity holders. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 207-208 (1988). On any sensible reading of the phrase "on account of," this plan allocates property to equity holders "on account of" their status as equity holders. First, it is only because they are equity holders that they have a right, often (as in this case) the exclusive right, to propose a plan of reorganization. See 11 U.S.C. § 1121. Second, under the plan which the equity holders proposed in this case, only equity holders receive the option to purchase a stake in the reorganized firm over the objections of the unsecured creditors. Under the statutory language, it is evident that the equity holders whose plan reserves this right to themselves receive equity in the reorganized firm "on account of" their status as prepetition equity holders. Accordingly, the Code expressly prohibits confirmation of this plan.

2. Prior practice under the old Bankruptcy Act does not justify a contrary conclusion. The Bankruptcy Act, superseded in 1979 by the Bankruptcy Code, required, in relevant part, that a plan of reorganization be "fair and equitable." 11 U.S.C. § 621(2) (1976). This Court interpreted this prior language to require that senior interests have absolute priority over junior interests. Junior interests could not be paid anything over the dissent of an unpaid senior creditor. While *dicta* in the 1939 decision of *Case v. Los Angeles Lumber*, 308 U.S. 106 (1939), intimated that there might have been an exception to this rule where old equity holders contributed money or money's worth to the reorganization effort, neither this Court nor any lower court applying the Act ever held that such an exception in fact existed. Bankruptcy law under the Act thus did not contain a well-developed "new value" exception to the absolute priority rule.

Even had the *dicta* in Case developed into settled law, there would be no new value exception under the Code. The new value exception suggested in *Case* applied only if all classes of creditors approved the plan of reorganization, and an *individual*, outvoted, creditor sought to block confirmation by invoking the absolute priority rule. The language of the new Code plainly states that only a dissenting *class* of creditors can invoke the absolute priority rule. Individual creditors whose class consents to the plan cannot veto the plan on the grounds that junior interests are receiving property. Thus, in every situation where the putative new value exception would have allowed confirmation of a plan under prior law—viz., where all creditor classes consent and a new contribution is made by prepetition equity holders—the Code now in fact requires confirmation. Appending the new value exception to cur-

rent law would grant equity holders a right they never possessed under the theory of the *Case* dicta, a right to retain an interest in the debtor over the objection of a class of unpaid creditors.

3. The plain language of the Code reflects a coherent view of bankruptcy policy. The Code puts the reorganization decision in the hands of the creditors, who are the residual owners of the insolvent firm. Here those creditors have decided to reject the plan proposed by the prepetition equity holders. It is important to emphasize that the question is not whether prepetition equity olders can participate in the reorganized debtor, they can. The question is who gets to decide—the debtor and the bankruptcy court, or the creditors. The Code leaves this decision to the creditors—those entities whose money is at stake in the reorganization decision. The creditors, via class voting, can decide to cede property to prepetition equity holders. If the equity holders cannot convince the creditors that such a concession is in the creditors' own interest, it makes little sense to allow a bankruptcy court to substitute its opinion for that of the creditors.

ARGUMENT

It is important to identify precisely what is at stake in this case. The question is not whether prepetition equity holders can receive property in the reorganization of a firm in Chapter 11. They can. Numerous plans of reorganization have been confirmed which allow for such participation. For example, a study of the reorganization of 30 insolvent, publicly traded firms, found that prepetition equity holders retained an interest in the reorganized firm in 21 of these cases, always with the consent of the unsecured creditors. See Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held* Companies, 139 U. Penn. L. Rev. 125, 143 (1990).[2] Rather, the

[2] For other studies reporting similar results, see Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under*

question before the Court is whether a bankruptcy court can approve a plan which grants the prepetition equity holders an interest in the reorganized firm over the objeciton of a class of unsecured creditors. The language, history and policies of the Bankruptcy Code dictate that it cannot.

I. THE PLAIN LANGUAGE OF THE BANKRUPTCY CODE REQUIRES REVERSAL

A. The Proposed Plan Grants Prepetition Equity Holders Property "On Account Of" Their Status As Equity Holders

This Court has previously explained that the absolute priority rule of the Bankruptcy Code "provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan." *Ahlers*, 485 U.S. at 202 (internal quotation marks and citation omitted). This case presents the issue of whether there is an unwritten exception to this rule of absolute priority—a so-called "new value" exception—which allows the bankruptcy court to approve, *over the unsecured creditors' objection*, a reorganization plan that allows prepetition equity holders to retain an interest in the reorganized firm if they make a new capital contribution to the reorganizing firm.

The Code provides that a bankruptcy court can approve a proposed plan of reorganization over the dissent of a class of unsecured creditors only if "the holder of any claim or interest that is junior to the claims of [the objecting] class will not receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. § 1129(b)(2)(B)(ii). The justification for

Chapter 11 of the Bankruptcy Code? (Pt. 2), 57 Am. Bankr. L.J. 247, 263-66 (1983); Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 Marq. L. Rev. 159, 165-183 (1987).

this requireemnt is readily apparent. When a firm is insolvent, the creditors' claims exceed the value of the firm's assets, and they are thus entitled to receive the entire value of these assets. A plan of reorganization which gives value to subordinate creditors or equity holders while more senior creditors are not being paid in full presents the danger that the lower class is receiving property which rightfully belongs to the senior class. Accordingly, the Code's absolute priority rule allows the senior creditors, as a class, to block that misappropriation.

The plan in this case gives the current equity holders the exclusive right to retain the equity interest in the reorganized firm in exchange for cash payments. Pet. App. 139a. This Court's decision in *Ahlers* makes clear that the interest that the equity holders are retaining is "property" as that term is used in the Code. See *Ahlers*, 485 U.S. at 208 (quoting *Northern Pacific R. Co. v. Boyd*, 228 U.S. at 508) (regardless of the current value of the reorganized firm, "a retained equity interest is a property interest to 'which the creditors [are] entitled * * * before the stockholders [can] retain it for any purpose whatever' "). Thus, the crucial statutory issue is whether the equity holders retain that property "on account of" their prior interest in the debtor.

The words "on account of" denote a causal relationship. See Random House Dictionary of the English Language 13 (2d ed. 1987) (on account of: "a. by reason of; because of. b. for the sake of"). The question is this case is whether the proposed plan, by allowing the prepetition equity holders to receive equity in the reorganized firm in exchange for cash payments, grants them property "on account of" their prepetition interests. Put differently, is being an equity holder a *cause* of receiving property under the proposed plan of reorganization? An examination of the reorganization procedures in Chapter 11 leaves no doubt that this is the case: absent the prepetition equity holders' interest in respondent, they would not have the

opportunity to receive any property under the proposed plan of reorganization.

First, only a debtor or a party in interest may file a plan of reorganization. See 11 U.S.C. § 1121. Outsiders are not allowed to file plans. The plan in this case was filed by the debtor, which is run for the benefit of the equity holders.[3] Absent the preexisting equity interest, the prepetition equity holders would have no basis on which they could even file a plan of reorganization. Moreover, no other party in interest would file a plan in this case which gave the prior equity holders the right to purchase the equity interest in the reorganized firm. Petitioner, the only secured claim holder and the major unsecured claim holder, has objected to this plan. There is no indication that the trade creditors would propose such a plan. Thus, only because the prepetition equity holders were equity holders were they permitted to file the plan gives them the option to purchase the equity interest in the firm. This is but one way in which the old equity holders are receiving the exclusive opportunity to purchase postpetition equity "on account of" their prepetition equity holdings.

Moreover, under Chapter 11, the debtor is given the exclusive right to file a proposed plan of reorganization for the first 120 days after the bankruptcy petition has been filed. This "exclusivity period" extends to 180 days if the debtor files a plan within the initial 120-day period. 11 U.S.C. § 1121(c). The bankruptcy court has the power to extend the exclusivity period beyond the 180-day limit. See 11 U.S.C. 1121(d). In many cases, courts

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[3] The debtor in this case is a limited partnership (Pet. App. 103a), and the limited partners are considered the debtor's equity holders under the Code. See 11 U.S.C. § 101 (16) & (17). A limited partnership is comprised of at least one general partner and limited partners, with the general partner owing fiduciary duties to the limited partners. See Harold Gill Reuschlein & William A. Gregory, The Law of Agency 444 (2d ed. 1989). Given these legal duties, it is fair to conclude that the debtor in proposing the plan is acting on behalf of its equity holders.

grant such extensions. See Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 Wisc. L. Rev. 729, 753 (reporting that in 79% of cases studied, exclusivity continued throughout the case). This is a case in point. The original and amended plans were filed within the exclusivity period. See Pet. App. 103a-04a. Petitioner moved to terminate the exclusivity period, so that it could file a competing plan. The Bankruptcy Court denied the motion and continued to extend the exclusivity period. See J.A. 16-17. Thus, as is quite common under prevailing practice, the debtor is the only party that ever has had an opportunity to file a plan of reorganization. By statutory prescription, the prepetition equity holders have the right to propose this plan of reorganization only because they are the prepetition equity holders.[4]

The ability to propose a plan of reorganization provides a significant advantage in the reorganization process. The Code specifies the minimum content of a plan of reorganization, and accords substantial discretion in the content of the plan to its proponent. Thus, the right to propose a plan of reorganization, whether exclusive or not, shapes the reorganization process. The right to make an offer, especially if it can be the only offer on the table, allows the party with that right to affect the terms of settlement. See Douglas G. Baird, Robert H. Gertner & Randal C. Picker, Game Theory and the Law 60 (1994) ("a game's

[4] Respondent in its Response in Opposition notes that petitioner moved to terminate respondent's exclusivity period, that the bankruptcy court denied this motion, and that petitioner did not appeal this denial. Opp. 16. Respondent asserts that this failure to appeal "waived" any argument based on exclusivity. *Id.* Respondent misses the point. Even if exclusivity were terminated, it would still be the case that the equity holders have the right to propose this plan because they are equity holders. To be sure, the value of that right varies depending on whether it is exclusive or not, but the question before the Court is not one of valuation, it is one of cause. Here, respondent's right to propose the plan, which happens to be exclusive, is a cause of their retaining property under the plan.

likely course of play is often determined by which party moves first"); LoPucki, *supra* at 753-54 (debtors use exclusivity to extract concessions from creditors).[5] Only if one were to ignore the origin of the new value plan at issue here could one even contemplate the notion that equity holders are not receiving the equity in the reorganized firm "on account of" their prepetition equity holdings.

Finally, and perhaps most importantly, under the plan in this case, only the debtor's prepetition equity holders were granted the option to purchase equity in the reorganized firm. Pet. App. 57a-58a. No other parties were offered the opportunity to either purchase equity on the same terms as the old owners, or even to bid against the old owners for the equity interest, offering *better* terms than the old equity holders. The old equity holders were granted the exclusive right to purchase postpetition equity. In short, one had to be a prepetition equity holder in order to receive the *right* to purchase equity under this plan of reorganization. Stated differently, the right of respondent's partners to acquire all of the equity under the plan is exclusive of the rights of all third parties to bid on or otherwise acquire that interest, *even if they would pay more than respondents' partners.*

[5] The value of this right stems from the fact that even unbiased courts can err, and anyone who proposes a plan or reorganization is aware of this fact. Consequently, if a prepetition equity owner offers a new cash contribution, that owner has an incentive to ask for too much in return. If the court recognizes that the proposed plan would overcompensate the equity owner, the court will refuse to confirm the plan over creditor objection, and the equity owner will gain nothing from its offer. But nothing is lost. If, in the alternative, the court errs and finds that the plan would properly compensate the equity owner for her contribution, then the equity owner would benefit. As a result, anyone who has a right to request cramdown can expect to gain from that right. While prepetition equity holders undoubtedly have a right under the Code to propose such a plan, it is this right which spawned the plan at issue in this case.

The exclusive nature of the preptition equity holders' right under the plan to purchase new equity violates the express terms of the Bankruptcy Code. The plan defines the class of those who can purchase new equity in terms of whether or not they were previous equity holders. They thus are receiving the exclusive right to acquire property—itself "property"—"on account of" their prepetition equity interests, in violation of Section 1129(b)(2)(B).

By themselves and together, these facts show that the plan of reorganization in this case allowed prepetition equity holders to retain the equity interest in the firm "on account of" their equity in the debtor. This the Bankruptcy Code expressly prohibits.

B. The Court of Appeals' Reading of Section 1129 (b)(2)(B) Is Erroneous

The Court of Appeals attempted to evade the plain language of the Code through a form of confession and avoidance. It acknowledged that having the status of a prepetition equity holder was a necessary condition to retaining the equity interest in the debtor. But the court also noted that having a prebankruptcy equity interest was not a sufficient condition for retaining that interest. It stated that the old equity holders' retention of their interest depends on their making a "new, substantial, necessary and fair infusion of capital." Pet. App. 17a.[6] According to the Court of Appeals, it is "on account of" the infusion of funds, *rather than* their status as prepetition

[6] While the Court of Appeals stated that the contribution of capital was "necessary" for a successful reorganization, it is hard to see how this is the case. The debtor is a partnership whose sole asset is 15 floors of an office building. Pet. App. 103a. There is no dispute as to the deployment of the debtor's assets in this case; the only issue is who retains the equity interest. Given this, it is hard to see how there is any "necessity" here for the equity holders' contribution. Such contribution may be necessary for their continued participation, but it is not necessary for a successful reorganization.

equiy holders, that renders the plan in compliance with the Code.

There are two flaws with this argument. First, the exclusive right to purchase postpetition equity is itself property. See *In re Coltex Loop Central Three Partners, L.P.*, 138 F.3d 39, 43 (2d Cir. 1998); *In re Bryson Properties*, 961 F.2d 496, 504 (4th Cir. 1992); *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1360 (7th Cir. 1990). The only ones who receive this right are the prepetition equity holders, and the only plausible basis on which they are receiving this right is their status as prepetition equity holders. Indeed, in this case, it is because the prepetition equity holders face substantial tax liability based on their equity holdings that they have proposed a plan which grants them the opportunity to purchase postpetition equity. Opp. 19.

Even if one were to focus solely on the purchase of postpetition equity rather than the right to make such a purchase, the Court of Appeals' argument fails. The court's conclusion rests on a non sequitur. To be sure, one of the conditions for the prepetition equity holders' ability to acquire the new equity under the plan is their monetary contribution to the reorganization. Nonetheless, this does not negate a second condition to their ownership of the reorganized firm: they also had to be prepetition equity holders. To repeat: were they not equity holders, they would not have the right to make such a monetary contribution in exchange for an equity interest.[7]

[7] There are a variety of academic proposals as to how to reform the Chapter 11 process. What is interesting to note about these proposals is that although some of them allow for current owners to bid for the firm, none of them gives the owners the exclusive right to do so. All require that such bids be subject to competing bids. See Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 69, 114-15 (1991) (endorsing policy of new value plans contingent on amending the Code to allow competing bids); Philippe Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform*, 3 J. L.

There are many reasons why the prepetition equity holders are allowed to retain the equity interest in this plan of reorganization. Some of these reasons relate to their being prepetition equity holders of respondent, one of them does not. It is quite uncontroversial to say that they retain their interest under the plan "on account of" their old equity *and* their new infusion of capital. Both are necessary conditions. The basic mistake of the Court of Appeals was to treat an instance of concurrent causation as if it were a case of superseding causation. This is a case of concurrent causation because both the equity holders' status as equity holders, and their infusion of new value, were necessary for approval of the plan. It does not follow from this that the infusion of new value somehow becomes the *only* cause of the equity holders' retention of property under this plan. Recognizing the various bases of the equity holders' participation in the proposed plan precludes confirmation of the plan over the objection of an impaired class of unsecured creditors. In short, the Court of Appeals read Section 1129(b) to forbid equity holder participation "*solely* on account of" prebankruptcy equity interests.[8] But the Code does not say "solely on account of"—it says "on account of." Given the undis-

Econ. & Org. 523, 533-36 (1992) (auction firm off to competing bids, which may include bids by management). Some have suggested caution in deciding to allow managers, who often are equity holders, from participating in the auction. See Robert G. Hansen & Randall S. Thomas, *Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance*, 18 Int'l Rev. L. & Econ. 159, 178-78 (1998). No scholarly commentator of which we are aware has argued that, as a normative matter, it would be desirable to limit the bidding for postpetition equity to prepetition equity holders.

[8] The Court of Appeals in *Bonner Mall* bolstered its reading of the statute by arguing that if Congress sought to reject new value plans, it would simply have deleted the words "on account of such junior claim or interest." See In re Bonner Mall Partnership, 2 F.3d 899, 909 (9th Cir. 1993). From this, the court reasoned that the "on account of" language is designed to allow new value plans because they are "on account of" something else. One problem with this argument is that the language at issue can readily have a meaning which does not relate to new value plans. For example, it commonly happens that an equity holder has both a claim based on funds lent and an equity interest in the firm. Thus, the "on account of" language ensures that an equity holder who also holds a debt claim can participate in the reorganization "on account of" its debt claim, but not "on account of" its equity interest.

puted fact that being a prepetition equity holder is a necessary condition to retaining equity in the new firm, the proposed plan of reorganization violates the plain language of the Bankruptcy Code.

C. Congress's Action in Enacting the Bankruptcy Code Implies That There Is No New Value Exception to the Absolute Priority Rule

This plain language reading of the statute is bolstered by the congressional treatment of an analogous issue—whether a bankruptcy court can approve a plan under which senior claim holders give up some of the value of their claim to lower classes while not paying dissenting intermediate classes in full. For example, assume that a debtor that files for Chapter 11 has assets worth $150, the senior, secured creditor is owed $120, with collateral worth $120, and the junior creditors are owed $100. The question at issue is whether the bankruptcy court could approve, over the dissent of the junior creditors, a plan of reorganization which gave $100 to the senior creditor, $30 to the junior creditors, and $20 to the equity holders. The senior creditor might want to give up this value because it believes that the continued participation of the old equity holders is necessary for a successful reorganization.

Were the Court of Appeals' understanding of Section 1129(b)(2)(B) correct, such a plan would be confirmable. The hypothetical plan, like the plan in this case, grants property to junior creditors for two concurrent reasons, only one of which is their status as equity holders.

Under the rationale of the opinion below, the argument would be straightforward: the equity holders would receive equity "on account of" the senior creditor's decision to transfer part of the value of its claim in exchange for their continued participation in the enterprise—rather than "on account of" their prepetition equity interest. This reading of the "on account of" language, like that of the Court of Appeals in this case, vests the provision with the meaning "solely on account of", and thus permits reorganizations in which equity holder status is a necessary, but not the sole, reason for the acquisition of the equity in the reorganized firm.[9]

Congress, however, has expressly forbidden this result in the hypothetical case discussed above.[10] The bill passed by the Senate contained language that would have allowed court approval of such plans in which a senior creditor transfers value to junior interests over the dissent of intermediate creditors. See S. 2266, 95th Cong., 2d Sess., § 1130(a)(9)(A) (allowing court approval so long as dissenting class receives "*value* no less than under a plan that is fair and equitable") (italics added); see also Senate Rep. No. 95-598, 95th Cong., 2d Sess. 127 (1978) ("Paragraph 9(a) would permit a senior creditor to adjust his participation for the benefit of stockholders. In such a case, junior creditors, who have not been satisfied in full, may not object if, absent the 'give-up', they are receiving all that a fair and equitable plan would give them."). The House version, in contrast, contained language that in relevant part is identical to that at issue in this case. See H.R. 8200, 95th Cong., 2d Sess. § 1129(b)(2)(B)(iv) (court can approve plan over dissent of unsecured creditors provided that "holders of claims or interests of any class or claims or interests, as the case may be, that is junior to such class *will not receive or retain under the plan on account of such junior claims or interests any property*") (italics added). The House Committee Report made clear that this language did not allow senior creditors to cede their value to lower classes without paying intermediate creditors in full or obtaining their consent. See House Rep. No. 95-595, 95th Cong., 1st Sess. 416 (1977) (The language in Section 1129 "is designed to prevent a senior class from giving up consideration to a junior class unless every intermediate junior class consents, is paid in full, or is unimpaired."). The bill as ultimately passed by Congress contained the language of the House bill. The floor statements that were made in lieu of a conference report note expressly that "the House report remains an accurate description of confirmation of section 1129(b). Contrary to the example in the Senate report, a senior class will not be able to give up value to a junior class over the dissent of an intervening class unless the intervening class receives the full amount, as opposed to value, of its claims or interests." 124 Cong. Rec. 32408 (Sept. 28, 1978). Congress thus expressly considered and rejected give up plans.[11]

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[9] It should be noted that if the Court of Appeals' reading were correct, it would call into question this Court's decision in *Ahlers*. The Ninth Circuit in *Bonner Mall* admitted as much. See 2 F.3d at 916 ("There is nothing in the text of the Code that prevents stockholders from obtaining property in the reorganized debtor in exchange for contributions of labor; such a transaction would not give old equity any property 'on account of' its prior ownership interests.").

[10] This rejection applies regardless of who proposes the plan.

[11] One can question the wisdom of this rejection. See Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. Chi. L. Rev. 738, 760-75 (1988). While Professors Baird and Jackson suggest that Congress should have allowed give up plans, they argue that where there is no such intermediate class, as in this case, courts should not second guess the decisions of the affected parties. See *id.* at 747-60. Indeed, while this Court never held that there was a new value exception to the absolute priority rule, see below, it did endorse give up plans. See *Kansas City Terminal Railway Co. v. Central Union Trust Co.*, 271 U.S. 445 (1926).

The import of this congressional rejection of give up plans is that new value plans must fail as well. Were a give up plan to come before a court, the same reading of the Code on which the Court of Appeals relied in this case would justify confirmation of such a plan over creditor objection. The proponent of such a plan would argue that the participation of the prepetition equity holders would be "on account of" the decision of the senior creditors to give up some of their claim because they had concluded that such participation was necessary to the successful reorganization of the firm. Structurally, the argument is identical to that pressed by the Court of Appeals here. New equity is given to prepetition equity holders *if* something else also happens—in new value plans, the equity holders choose to make cash contributions; in give up plans, senior claimants choose to transfer value to equity holders. The Court of Appeals' approach looks solely to the *contingent* fact—a choice made by one of the parties—while ignoring the background, *non-contingent* requirement in both situations—that the right to purchase postpetition equity is limited to prepetition equity holders. When Congress rejected this reasoning in the case of give up plans; it also implicitly rejected the same argument based on identical language as applied to new value plans. This Court should not resolve this case in a way that would lead to application of the statute in a way so plainly inconsistent with Congress's considered treatment of an analytically indistinguishable situation.

II. PRIOR PRACTICE UNDER THE BANKRUPTCY ACT COMPORTS WITH THE PLAIN LANGUAGE OF THE BANKRUPTCY CODE

In addition to their statutory argument, the proponents of the new value theory advance a dubious historical argument. They assert that the practice prior to the adoption of the Code allowed for the approval of new value plans. See Pet. App. 20a; *Bonner Mall*, 2 F.3d at 912-13; *In re Synder*, 967 F.2d 1126, 1129 (7th Cir. 1992). They then invoke the "canon" of statutory construction that, in bankruptcy cases, "th[e] Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992).

In light of the clarity of Section 1129(b)(2)(B), this canon has no application to this case. As explained above, Congress did not authorize new value plans when it drafted Chapter 11. Moreover, even if the language of Section 1129 and the overall structure of Chapter 11 were ambiguous on this point, a holding from this Court that there is no new value exception would not be a major change from pre-Code practice. If anything, creating such an exception under the current voting scheme in Chapter 11 would be a significant departure from prior practice; it would allow approval of plans that could not have been approved under prior law.[12]

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[12] Before examining the state of the law prior to the passage of the Code, we first pause to question this "deference to past practice" approach to interpreting the Bankruptcy Code. In enacting the Code, Congress did not amend the Bankruptcy Act; it replaced it in its entirety. In Chapter 11, for example, Congress wrote a single provision for business reorganizations whereas prior law had three such provisions: Chapter X, Chapter XI and Chapter XII. These three provisions had differing standards for confirming plans of reorganization, and it was a major policy decision to switch to a universal Chapter 11. See J. Ronald Trost, et al., The New Federal Bankruptcy Code 239-40 (ALI 1979). While pre-Code practice may explain choices that Congress made, it is hard to see why there should be a presumption in favor of the law which Congress found inadequate.

The Court first articulated the "deference to past bankruptcy practice" rule in *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494 (1986). There the Court stated: "The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation

The putative new value exception to the absolute priority rule stems from *dicta* in this Court's decision in *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121-22 (1939). In that case the Court, speaking through Justice Douglas, stated that equity holders could participate in a reorganized firm where "the necessity * * * of seeking new money [was] essential to the success of the undertaking". Id. at 121. This statement was dicta, for the Court ultimately held that the proposed contribution at issue was not sufficient. Id. at 122-23. This Court never ruled on the existence of a new value exception. See *Kham & Nate's Shoes No. 2*, 908 F.2d at 1360.[13] More-

of a judicially created concept, it makes that intent specific. *Edmonds v. Compagnie Generale Transatlantique*, 443 U.S. 256, 266-67 (1979). This Court has followed this rule with particular care in construing the scope of bankruptcy codifications." Even if this were the case with prior legislation in the bankruptcy area, it is hard to see why it should be so with current law.

If anything, one would imagine that the process which generated the Bankruptcy Code would lead to the conclusion that less deference should be accorded to past practice than is the case in other instances of statutory amendment. Congress focused on the need to revisit this country's bankruptcy laws in 1968, when it created a commission to study the need for major reform. The bankruptcy commission issued its final report in 1973. A group of bankruptcy judges, infuriated by their exclusion from the Commission, created their own bill. In 1974 both bills were introduced in Congress, and lengthy hearings were held in 1975 and 1976. These hearings led to new bills being introduced in the House and Senate, and a new round of hearings. The new Bankruptcy Code was eventually passed in 1978. See Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 Mich. L. Rev. 47, 67-74 (1997). Given this careful and extensive consideration of the Bankruptcy Code, and given the comprehensive overhaul that the Code provided, it is counterintuitive to venerate past practice. The Bankruptcy Act was out of date, and Congress undertook the review process because it wanted to remedy this defect. Congress clearly was reforming bankruptcy law here, not enshrining it.

[13] The sugestion by the court in *Bonner Mall* that the Supreme Court held that the new value exception exists in *Mason v. Paradise*

over, there are no reported lower court cases applying this exception prior to the passage of the Bankruptcy Code. See John D. Ayer, *Rethinking Absolute Priority after Ahlers*, 87 Mich. L. Rev. 963, 1016 (1989). There was no well-established new value exception to the absolute priority rule based on pre-Code practice.[14]

Any basis for even this tenuous historical claim has been removed by the fundamental change in reorganization law under the Code of 1978. To understand the nature of this change, it is helpful to examine the treatment of business bankruptcies under the prior Bankruptcy Act. The Act had three different chapters for business reorganizations—Chapters X, XI, and XII. In general, Chapter X was designed for publicly held firms, Chapter XI for privately held firms, and Chapter XII for real

Irrigation Dist., 326 U.S. 536, 541-42 (1946), misreads that opinion. The debtor in *Mason* had issued bonds which it could not pay. The Reconstruction Finance Corporation ("RFC") proposed to refinance the bonds at 52.521 cents on the dollar. *Id.* at 539. The holders of 92 percent of the bonds agreed to this refinancing, and sold their bonds to the RFC. *Id.* The debtor filed a petition under Chapter IX to force the remaining 8 percent of the bondholders to agree to this refinancing. *Id.* The plan of reorganization in *Mason* gave cash at 52.521 cents on the dollar to the bondholders who had not sold to the RFC, and gave new bonds, at 52.521 cents on the dollar to the RFC. *Id.* at 539-40. The new bonds carried a 4 per cent interest rate. *Id.* at 540. The Court held that this difference in treatment was allowable because the RFC, through its purchase of the outstanding bonds, had refinanced the debtor's operations. (In effect, it converted $476,000 of bonds at 6 per cent to $252,500 at 4 per cent). *Id.* at 541-42. Moreover, the Court noted that there was no showing that the bonds received by the RFC were more valuable than the cash given to the other bondholders. *Id.* at 543. *Mason* thus is a case about permissible differences in treatment of creditors holding the same claim; it does not involve absolute priority.

[14] This lack of historical implementation of the new value exception to the absolute priority undermines the court of appeals' statement that "[t]he new value corollary has been a major source of new funding in reorganizations for the past fifty years." Pet. App. 21a.

estate firms. After 1952, only Chapter X required that a reorganization plan be "fair and equitable." [15]

Case was decided under the predecessor to Chapter X—Section 77B—which required that a plan of reorganization be "fair and equitable." This test had to be met even if all classes of creditors approved the plan. See 308 U.S. at 114. In other words, the absolute priority rule could be invoked by an individual creditor to challenge a plan as not "fair and equitable" even if the class of which it was a member had consented to the plan of reorganization. Approval of a new value plan under the *Case* dicta required *both* class approval *and* a finding by the bankruptcy court that the stockholders were making a necessary contribution of capital to the new firm. This requirement of class consent means that the plan in this case could not have been confirmed under the Act. The new Code made confirmatiton easier in that class approval binds dissenting class members; *individual* creditors are no longer able to invoke the absolute priority rule. Thus, whereas the plan in this case would not have been approved under the Act, the plan in *Case* would have been approved under the Code.

We emphasize the extent to which the Court of Appeals' holding—that there is a new value exception to the absolute priority rule—deviates from prior law. Under

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[15] Chapters XI and XII, as originally enacted, also required plans to be "fair and equitable." After the Supreme Court made clear that "fair and equitable" required adherence to absolute priority, Congress deleted this requirement from Chapters XI and XII, but left it in Chapter X. See Act of July 7, 1952, ch. 579 §§ 35, 43 & 50; see also H.R. Rep. No. 2320, 82d Cong., 2d Sess. (1952), *reprinted in* 1952 U.S.C.C.A.N. 1960, 1981-82 (explaining that change was in reaction to *Boyd* and *Case*). That the absolute priority rule only applied in Chapter X explains the dearth of reported cases on the new value exception under the Act. Not only were there few cases under Chapter X, but also these are the type of firms—publicly held companies—most likely to attract outside financing.

pre-Code practice, shareholders who wanted to retain an equity interest in the reorganized firm both had to secure consent of all classes of creditors *and* make a contribution which satisfied the new value test. Congress in the Code made it clear that consent of creditor classes would be sufficient to approve a plan of reorganization in which the prepetition equity holders received an interest, regardless of whether the equity holders were making any new contribution. Under the Code, if all the creditor classes agree that the value of equity holders' continuation in the firm exceeds what they are to receive under the plan of reorganization, this agreement binds all creditors. The Court of Appeals held that, in the absence of creditor consent, equity holders could retain an interest so long as they made a new contribution. Algebraically, the Act required A + B for confirmation; Congress then enacted the Code, which requires only A for confirmation; the Court of Appeals held that a plan can be confirmed based on B alone. Whatever the merits of the Court of Appeals holding, it is not consistent with past practice.

III. SOUND BANKRUPTCY POLICY SUPPORTS THE PLAIN LANGUAGE OF THE BANKRUPTCY CODE

Policy arguments support the reading of the Code set forth above. To see why this is so, consider the structure of the Chapter 11 reorganization process. Chapter 11 provides a forum in which the decision is made whether to liquidate [16] or reorganize the debtor, and, if the debtor is to be reorganized, how the debtor's assets should be deployed and what capital structure the reorganized firm should have. A Chapter 11 reorganization is premised on

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[16] Liquidation can occur either through a transfer to Chapter 7, or the approval of a liquidating plan of reorganization. In one study, liquidating plans of reorganization comprised about one quarter of all confirmed Chapter 11 plans. See Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 Com. L.J. 297, 318-19 (1992).

bargaining among the affected parties. See House Report, *supra*, at 224 ("[N]egotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders."). Crucial to this negotiation is the plan of reorganization; it is the plan that sets forth the future of the firm. The Code allows the plan proponent to classify claims into classes. See 11 U.S.C. § 1123(a)(1). Holders of claims have two distinct sets of rights: those that they possess individually, and those that they possess as a member of the class in which they are included. Individually, each claim holder is entitled to receive no less than it would have received in a Chapter 7 liquidation of the firm. 11 U.S.C. § 1129(a)(7). As a member of a class, each holder has a vote. For a class to approve a plan, over half of the holders, whose claims total more than two-thirds of the amount of claims in the class, have to vote in favor of the plan. 11 U.S.C. § 1126. To the extent that a class objects, the rights of the class turn on whether the claim is secured or unsecured. If it is secured, the plan can be confirmed only if the dissenting class is to receive the full present value of its claim under the plan. See 11 U.S.C. § 1129(b)(2)(A). If the dissenting class is unsecured, the plan can be confirmed only if the class is paid in full or if no junior claims or interests "receive or retain * * * on account of such junior claim or interest any property." 11 U.S.C. § 1129(b)(2)(B).

The logic behind this scheme is sound. It vests the party with the largest incentive to maximize firm value with the decision as to the firm's future. To the extent that the firm is worth less than the sum of its parts, any individual creditor can scuttle the reorganization effort by insisting on its right to be paid what it would have received in a Chapter 7 liquidation. Assuming that the firm is worth more kept together than it would be if liquidated, the exact division of the firm is left to negotiation among the parties. It is important to note that in these negotiations much is unceratin. The value of the reorganized firm is often subject to dispute. Moreover, the value of the contributions made by prepetition equity holders, both monetarily and in managing the firm, is also often unclear. The Chapter 11 rules set the terms of the negotiation. Absent any putative new value exception, these rules let the parties whose money is at stake select what they view as both the future value of the firm and the value of the continued participation by the equity holders. The prepetition equity holders are entitled to make the opening offer. They can overcome the dissent of the secured creditors by paying them the full amount of their claims. Since the claims of the secured creditors are defined by the value of their collateral, 11 U.S.C. 506(a), there always should be sufficient value to pay them off in full.

When a debtor is insolvent, the unsecured claims cannot be paid in full. The creditors who are not to be paid in full, however, have the appropriate incentives to make the choice which maximizes the value of the firm. If the prepetition equity holders propose to make contributions to the firm in excess of the value which they are receiving, the unsecured creditors can vote for the plan. If they believe either that the prepetition equity holders participation is not necessary for an effective plan of reorganization, or that the prepetition equity holders propose to take too much in exchange for their contribution, they can vote against the plan. Thus, to the extent that the equity holders can convince the marginal claimants that the holders are necessary to the reorganization effort, they can participate in the reorganized firm under any plausible reading of the Code.

The new value exception found by the Court of Appeals in this case distorts this negotiation. It asks the bankruptcy court to second guess the decision made by the unsecured creditors. It asks the court to determine whether the contribtuion made by the prepetition equity holders is necessary to an effective reorganization, and whether

the interest retained under the plan is reasonably equivalent to the interest contributed. Creditors can no longer make proposals and vote based on their view of the correct division of the firm. Rather, they have to take account of the fact that, if they dissent from a plan because they are not being paid in full and they believe that the equity holders are receiving more under the plan than they are contributing, then the bankruptcy court may nevertheless approve such a plan over their objections.

There is no reason to substitute the judgment of the bankruptcy court for that of the creditors. Creditors that are not being paid in full have the strongest incentives to maximize firm value. If the firm turns out to be worth more, they stand to benefit. If the firm turns out to be worth less, they suffer the loss. It is hard to imagine why, over the broad range of cases, the bankruptcy court is in a better position to decide the value of the continued participation of the prepetition equity holders than are the parties whose money is at stake.

The major policy argument offered in favor of the new value exception is the argument that shareholders are a necessary source of new funding for reorganization efforts. See Pet. App. 21a; *Bonner Mall*, 2 F.3d at 915. This argument, not supported by statutory text, should be addressed to Congress. Moreover, it is unclear that this particular argument has any merit. First, if the old equity holders are in fact making a valuable contribution to the reorganization effort, the creditors that are not being paid in full more than likely would consent to the proposed plan. Second, the "necessity" argument is premised on the assumption that capital markets are not able to fund worthwhile reorganization efforts. However, a recent study of distressed debt discovered that, in most cases in which a loan becomes distressed, the owners of the firm are able to secure new funding or reach an accommodation with the lender. See Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 Mich. L. Rev. 159, 182-83, 192-94, 208-09 (1997). This appears

to have been the case at the time that the Code was enacted. See Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. Chi. L. Rev. 651, 672 (1974) ("Current data do not support the belief that old shareholders are a fruitful source of additional funds when the public capital markets are unlikely to provide funds. In recent years shareholders have seldom contributed new capital."). Although some distressed debtors might have difficulty locating financing, that is not proof of a problem. The availability of funding for many distressed debtors suggests that the difficulty that some face might be entirely appropriate. Given the evidence suggesting a well-functioning market for financing these borrowers, the broad speculation of the Court of Appeals should not be credited.

The other policy argument which has been invoked in favor of the new value exception is that Congress attempted through Chapter 11 to encourage reorganizations, and since the new value plans at issue are "necessary" for an effective reorganization, they should be approved. See *Bonner Mall*, 2 F.3d at 916. The problem with this argument is not the premise, which is undoubtedly true: Congress *did* intend to promote reorganizations through Chapter 11,[17] and the removal of the right to invoke the absolute priority rule from individual creditors was a major advancement toward promoting reorganizations. The problem with the argument is its conclusion: simply because Congress wanted to promote reorganizations in general does not justify the inference that it sanctioned the new value exception to the absolute priority rule. Congress did not enact every pro-reorganization rule that one could imagine. Give-up plans, mentioned above, also may have had the effect of promoting reorganizations, but Con-

[17] While Chapter 11 has in fact promoted reorganizations, it has not promoted successful reorganizations. See Jensen-Conklin, *supra*, at 323-25 (6.5% of cases studied resulted in a confirmed and consummated plan); see also LoPucki & Whitford, *supra*, at 608 (52% of large, publicly held corporations filed a second Chapter 11 petition after having confirmed a plan of reorganization).

gress rejected them. Thus, the general preference toward reorganization is not enough to overcome the lack of textual and historical support for a new value exception.

The language, history and policies of the Bankruptcy Code lead to the same conclusion. Section 1129 prohibits confirmation of a plan, proposed by the prepetition equity holders, which grants them an exclusive right to purchase equity in the new firm over the dissent of a class of creditors which is not being paid in full.

CONCLUSION

The judgment of the Court of Appeals should be reversed.

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